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DISCLOSURE OF PRELIMINARY MERGER NEGOTIATIONS—TRUTH OR CONSEQUENCES?

DANIEL L. GOELZER*

Must a publicly-traded company disclose that it is involved in confidential merger negotiations when those negotiations have not yet resulted (and may never result) in a definitive agreement as to the price and structure of the transaction? When, if ever, may a public company engaged in such preliminary negotiations issue a statement falsely denying their existence? If the insiders of a negotiating company purchase the acquiree company's stock—stock sure to increase in value if a nascent merger comes to fruition—without informing the selling shareholders, do the purchasers violate the prohibitions against insider trading?

The answers to these questions depend in part on whether preliminary merger negotiations are deemed material within the meaning of Securities and Exchange Commission rule 10b-5. False statements concerning publicly-traded securities, or failures to state information, are actionable under rule 10b-5 only if the misstated or omitted fact is material. At first blush, the materiality of a possible merger would seem beyond cavil. As one court has recently observed: "[O]nly an addleheaded investor would consider . . . unimportant in" making investment decisions the difference between the current market value and the price at which a potential merger is likely to be consummated.¹ Nonetheless, the federal courts of appeals that have considered the question have reached conflicting results. The Third and Seventh Circuits have held that such negotiations are immaterial as a matter of law, unless and until the negotiating parties actually agree on the price and structure of a merger. The Sixth Circuit, in contrast, has rejected the price and structure rule. The Second Circuit, while paying some lip service to the rule, has not squarely addressed it.

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1. *Flamm v. Eberstadt*, 814 F.2d 1169, 1174 (7th Cir. 1987).

The Securities and Exchange Commission, not surprisingly, has taken the position that all statements by issuers and acquirors must be materially accurate and complete. The Commission has made clear that false public statements denying that merger negotiations are pending can violate rule 10b-5. In the Commission's view, statements concerning preliminary merger negotiations must be analyzed within the same framework as statements concerning any other corporate development. Thus, the Commission has rejected the price and structure rule. Rather, the Commission has stated that the materiality of merger negotiations depends on a balancing of the likelihood that the negotiations will ripen into a transaction and the magnitude of the merger (*i.e.*, its importance to shareholders) if it does occur.²

The Supreme Court has granted certiorari in order to resolve these conflicting views.³ This article examines the background against which the Court will resolve this fundamental issue.⁴

I. DUTY TO DISCLOSE MERGER NEGOTIATIONS

The question of whether a particular fact must be disclosed under rule 10b-5 requires the analysis of two distinct issues. First, is there a duty to disclose the fact, and second, is the fact material? Much of the confusion in the case law stems from the failure of the courts to distinguish between these inquiries. As a result, some courts seem to have implicitly assumed that if otherwise confidential merger negotiations are material, they must be disclosed to the public. The assumption that all material negotiations must necessarily be disclosed has led these courts to formulate narrow tests of materiality. In fact, there is no general duty to disclose preliminary merger negotiations. Although there are some exceptions, a public

2. See, *e.g.*, In the Matter of Carnation Co., Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985) [hereinafter *Carnation release*].

3. *Levinson v. Basic Inc.*, 786 F.2d 741 (6th Cir. 1986), *cert. granted*, 107 S. Ct. 1284 (1987).

4. The materiality of preliminary merger negotiations has been the subject of considerable recent commentary. See, *e.g.*, Brodsky, *Disclosure of Merger Negotiations*, N.Y.L.J., Nov. 6, 1985, at 1, col. 1; Brown, *Corporate Communications and the Federal Securities Laws*, 53 GEO. WASH. L. REV. 741, 782-92 (1985); Goldstein, Donnelly & Wurzinger, *Disclosure of a Potential Change in Corporate Control*, 19 REV. SEC. & COMMODITIES REG. 133 (1986); Greene, *Public Disclosure of Merger Negotiations*, N.Y.L.J., Oct. 24, 1985, at 1, col. 1; Posner, *Surprise! The SEC Says You Shouldn't Tell Lies About Merger Negotiations*, INVESTMENT DEALERS' DIGEST, Aug. 26, 1985, at 36; Olson, *Revealing Merger Talks: When, How are Critical*, Legal Times, Oct. 14, 1985, at 11, col. 1. See also Note, *Disclosure of Preliminary Merger Negotiations Under Rule 10b-5*, 62 WASH. L. REV. 81 (1987).

company is generally entitled to maintain confidentiality, even if the negotiations are material.

There are, however, important exceptions to this corporate right to remain silent. These exceptions, in which a public company is obligated to disclose ongoing, confidential merger negotiations, are derived from three sources: rule 10b-5 itself; specific Commission "line item" disclosure requirements;⁵ and stock exchange or National Association of Securities Dealers (NASD) listing standards. Since the question of whether merger negotiations are material is moot absent a duty to disclose them, it is useful to review the outlines of these duties before examining the question of materiality.

A. Rule 10b-5

Rule 10b-5 is a general prohibition against fraud and the misstatement or omission of material facts in connection with the purchase and sale of securities.⁶ Rule 10b-5 does not, by its terms, require the disclosure of any particular information, nor does it refer to preliminary merger negotiations. Rule 10b-5 may, however, compel a public company⁷ to make disclosure of material facts concerning preliminary merger negotiations in three situations: when the issuing company trades in its own stock; when prior public statements concerning the company have become misleading; and when the corporation chooses to speak voluntarily.

1. *Issuer "Insider" Trading.*—Rule 10b-5 precludes anyone, including the issuing company, from purchasing or selling a security while in possession of material, nonpublic information concerning

5. "Line item" refers to Commission rules directing that certain information be disclosed in public documents filed with the Commission. In some cases, line item requirements are qualified by a materiality standard—responsive information need only be disclosed if material. In other cases, responsive information must be disclosed regardless of materiality.

6. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1951), provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

- (a) to employ any device, scheme, or artifice to defraud,
- (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

7. Rule 10b-5 encompasses any purchase or sale of securities, regardless of whether the issuer of the security is publicly or closely held. See *infra* note 74.

the security, if the trader is under a duty not to use the information.⁸ Determining precisely what duties are encompassed within rule 10b-5 has been a central issue in the law of insider trading.⁹ It is well-settled, however, that the issuing company itself owes a fiduciary duty not to use corporate information to profit at the expense of its own shareholders. Thus, the issuer may not trade in its own shares while in possession of material, nonpublic information.¹⁰ Accordingly, if ongoing preliminary merger negotiations are material, the company must either refrain from trading in its securities or make disclosure of the negotiations. On the other hand, if the merger negotiations are not material, the company (at least as a matter of rule 10b-5 law) may presumably purchase its own shares from investors, even though the company is aware of the possibility that the inchoate merger will dramatically increase the value of those shares.

2. *Corrections and Updates of Prior Corporate Statements.*—Rule 10b-5 has also been held to create a requirement that publicly-traded companies correct prior public statements that have become inaccurate or misleading. “It is now clear that there is a duty to correct or revise a prior statement which was accurate when made but which has become misleading due to subsequent events.”¹¹ Moreover, the company may also be obligated to correct statements by third parties or even rumors¹² which are attributable to the company.¹³

8. See *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

9. See, e.g., *United States v. Carpenter*, 791 F.2d 1024, 1026 (2d Cir.), cert. granted, 107 S. Ct. 666 (1986) (trading in breach of newspaper's policy prohibiting employee use of information gathered in the course of journalistic endeavors); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985) (trading in breach of financial printer's policy prohibiting employees from using information entrusted to employer by customers); *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985) (trading in breach of expectation of confidentiality between father and son).

10. See *Jordan v. Duff and Phelps, Inc.*, 815 F.2d 429, 435 (7th Cir. 1987); *Staffin v. Greenberg*, 672 F.2d 1196, 1204 (3d Cir. 1982); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir.), cert. denied, 419 U.S. 830 (1974); *State Teachers Retirement Bd. v. Fluor Corp.*, 500 F. Supp. 278 (S.D.N.Y. 1980), *aff'd in relevant part*, 654 F.2d 843 (2d Cir. 1981).

11. *Ross v. A.H. Robins Co.*, 465 F. Supp. 904, 908 (S.D.N.Y.), *rev'd on other grounds*, 607 F.2d 545 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980). See also *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 759-60 (3d Cir. 1984), cert. denied, 469 U.S. 1215 (1985); *Sharp v. Coopers & Lybrand*, 83 F.R.D. 343, 346 (E.D. Pa. 1979) (fraud within rule 10b-5 includes “a failure to correct a misleading impression left by a statement already made . . .”).

12. *State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d at 850 (holding that company has no duty to correct or verify rumors unless attributable to it).

13. Compare *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163 (2d Cir. 1980) (hold-

This duty, however, is not unlimited. It exists only while the prior statement "remains alive" in the sense that investors are relying on its accuracy and is, therefore, influencing the trading market for that security. Once the statement can no longer reasonably be viewed as operative, correction is no longer required.¹⁴ Thus, if a company has issued a public statement denying the existence of merger negotiations, and merger negotiations later commence, it may be obligated to disclose those negotiations, if the denial is still "alive" in the market and if the negotiations are material.

3. *Voluntary Corporate Statements.*—Three of the leading decisions concerning the materiality of merger negotiations—*Levinson*, *Heublein* and *Carnation*—involve voluntary corporate statements. Rule 10b-5 requires that if a corporation chooses to speak voluntarily, its statements must be truthful and complete in all material respects.¹⁵ This prohibition is triggered whenever the issuer speaks, regardless of whether the issuer is trading in its own securities or is otherwise required to disclose material facts:

The importance of accurate and complete issuer disclosure to the integrity of the securities markets cannot be overemphasized. To the extent that investors cannot rely upon the accuracy and completeness of issuer statements, they will be less likely to invest, thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike.¹⁶

Thus, while the securities laws do not obligate companies to issue public statements concerning merger negotiations, a company that chooses to speak cannot make a materially false or materially misleading statement about ongoing negotiations.

ing that issuer may be so deeply involved in preparation of outsider's projections that it "assume[d] a duty to correct material errors in those projections") with *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 949 (2d Cir. 1969) (finding no duty to correct statement not attributable to issuer). See also *Green v. Jankop*, 358 F. Supp. 413, 418-19 (D. Or. 1973) (holding company obligated to correct statements issued by its investment banker).

14. *Ross v. A.H. Robins Co.*, 465 F. Supp. at 908 ("[L]ogic compels the conclusion that time may render statements immaterial and end any duty to correct or revise them."). See also *Warner Communications v. Murdoch*, 581 F. Supp. 1482, 1489-90 n.13 (D. Del. 1984) (doubt as to whether misrepresentation in 1975 proxy statement has a continuing materiality to unrelated securities transactions in 1983).

15. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860-62 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); *Schlanger v. Four-Phase Sys., Inc.*, 582 F. Supp. 128, 133 (S.D.N.Y. 1984).

16. *Carnation* release, *supra* note 2, at 87,595.

B. "Line Item" Requirements

Several Commission rules create specific line item disclosure requirements that may, in some cases, compel disclosure of otherwise nonpublic preliminary merger negotiations. For example, Securities Act rule 408¹⁷ and Securities Exchange Act rule 12b-20¹⁸ respectively require that, in any registration statement filed under the Securities Act of 1933 and in any statement or report filed under the Securities Exchange Act of 1934, a company must include such information as is "necessary to make the required statements, in light of the circumstances under which they are made, not misleading."¹⁹

In addition, item 4 of schedule 13D may compel the other party to the merger negotiations to make disclosure. Section 13(d)(1) of the Securities Exchange Act²⁰ requires that, within ten days of acquiring more than five percent of a class of securities of a publicly-traded company, the acquiring person must file a schedule 13D with the Commission. Item 4 of schedule 13D requires a description of any "plans or proposals" of the acquiring person that would result in any of ten specified corporate events.²¹ When the five percent holder is negotiating a merger with the company, item 4 may require disclosure of those negotiations. And, even when no such negotiations are ongoing at the time of the initial schedule 13D filing, a "prompt"²² amendment to disclose any change in the content of schedule 13D, including the change in the item 4 information, must

17. 17 C.F.R. § 230.408 (1986).

18. 17 C.F.R. § 240.12b-20 (1986).

19. *Id.* A registration statement under the Securities Act of 1933 is filed when the company contemplates a public offering of its securities. See 15 U.S.C. § 77e (1982). Thus, whether or not disclosure of pending preliminary merger negotiations would be required under rule 408, rule 10b-5 presumably requires such disclosure, if the negotiations are material. Under the Securities Exchange Act of 1934, publicly-traded companies are required to file annual reports on form 10-K, quarterly reports on form 10-Q, and reports on form 8-K when certain significant events occur. 15 U.S.C. § 78m (1982). Rule 12b-20 would require the disclosure of preliminary merger negotiations whenever such disclosure is necessary to make the content of these filings not misleading.

20. 15 U.S.C. § 78m(d)(1) (1982).

21. These events include an "extraordinary corporate transaction, such as a merger, reorganization, or liquidation, involving the issuer or any of its subsidiaries" 17 C.F.R. § 240.13d-101, item 4.

22. The Commission has stated that "promptness" must be determined on a case-by-case basis. See *In the Matter of Cooper Laboratories, Inc.*, Exchange Act Release No. 22,171, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,788, at 87,526 (July 3, 1985). In *Cooper* the Commission found that in the case of a schedule 13D indicating the possibility of further acquisitions of the issuer's shares, an amendment filed *after* the acquiror had, in fact, sold all of its holdings, and seven days after the beginning of the liquidation process, was not prompt.

be filed.²³

Finally, the Commission disclosure requirement in item 7(a) of schedule 14D-9 refers specifically to merger negotiations.²⁴ Schedule 14D-9 must be filed by an issuer making a recommendation to its shareholders with respect to another person's tender offer for the issuer's securities.²⁵ Item 7(a) of schedule 14D-9 requires the target company to state whether it is engaging in any negotiations in response to the bidder's tender offer that would result in, among other things, an "extraordinary transaction such as a merger or reorganization"²⁶ Item 7(b), in contrast, requires the issuer to describe any "agreement in principle" that would result in, among other things, such a merger. In the release announcing the adoption of rule 14d-9, the Commission stated that "the major developments referred to in item 7 can be one of the most material items of information received by security holders."²⁷

The instructions to item 7(a) recognize that negotiations do occur prior to an agreement in principle. Accordingly, a target company need not disclose "the possible terms of any transactions or the parties thereto . . . if in the opinion of the Board of Directors of the subject company such a disclosure would jeopardize continuation of such negotiations."²⁸ In those circumstances "disclosure that negotiations are being undertaken or are underway and are in the preliminary stages will be sufficient."²⁹

The Commission recently issued an opinion, *In the Matter of Revlon, Inc.*,³⁰ setting forth the circumstances under which item 7(a) requires disclosure of negotiations. Revlon was engaged in negotia-

23. Securities Exchange Act § 13(d)(2), 15 U.S.C. § 78m(d)(2) (1982).

24. For other examples of references to merger negotiations, see the disclosure requirements in item 3(b) of schedule 14D-5, item 504 of regulation S-K, instruction 6, and item 3(b) of schedule 13E-3.

25. Securities Exchange Act § 14(d)(4), 15 U.S.C. § 78n(d)(4) (1982), authorizes the Commission to regulate recommendations to accept or reject a tender offer. Rule 14e-2, 17 C.F.R. § 240.14e-2 (1986), requires the target company to inform its shareholders whether or not it recommends (or takes no position on) acceptance of the bidder's offer. Rule 14d-9 requires that recommendations for or against acceptance of a tender offer be filed on schedule 14D-9. The requirements of schedule 14D-9 are set forth in 17 C.F.R. § 240.14d-101.

26. 17 C.F.R. § 240.14d-101, item 7(a) (1986).

27. Tender Offers, Rules, Exchange Act Release No. 16,384, [1979-1980 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 82,373, at 82,594 (Nov. 29, 1979). See 17 C.F.R. § 240.14d-9.

28. 17 C.F.R. § 240.14d-101, item 7, instructions (1986).

29. *Id.*

30. Exchange Act Release No. 23,320, [1986-1987 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 84,006 (June 16, 1986).

tions to sell part of its business as a counter-maneuver to fend off a pending tender offer by Pantry Pride. In its schedule 14D-9 Revlon stated that its Board of Directors had rejected Pantry Pride's offer as inadequate and had adopted certain defensive measures. In response to item 7(a) Revlon stated that it "may undertake negotiations which relate to or could result in" any of the various extraordinary corporate events specified in item 7(a), but that "[c]urrently, however, no negotiations have been undertaken with third parties."³¹ Although Revlon subsequently modified this statement, the company did not disclose that it was actually engaged in negotiations until the day before the friendly merger agreement and asset sales were announced.

In its order the Commission concluded that the discussions leading up to this agreement constituted negotiations required to be disclosed under item 7(a):

The term "negotiations" should not be interpreted in a technical and restrictive manner. *See Levinson v. Basic Inc.*, 786 F. 2d 741, 747 (6th Cir. 1986). As used in item 7(a), the term "negotiations" includes not only final price bargaining, but also applies to substantive discussions between the parties or their legal and financial advisers concerning a possible transaction.³²

Discussions constituted "negotiations" by the time that the following events had occurred:

[T]he parties had established contact, had begun and concluded their initial reviews of confidential financial information, had retained counsel to discuss between and among themselves the structure and timing of the acquisitions, and had discussed the percentage of equity to be offered to . . . the Revlon management group. . . . [An offer had been presented] which, although rejected, became the basis upon which the parties negotiated, including discussions . . . over the structure of the . . . [transactions].³³

The Commission concluded that Revlon's schedule 14D-9 statement that Revlon "may undertake" negotiations inaccurately implied that no negotiations were underway.

The obligation to disclose preliminary merger negotiations pur-

31. 35 SEC Docket at 1543. In addition, as authorized under the item 7(a) instructions, Revlon stated that it would not disclose the parties or possible terms of any transaction until an agreement in principle was reached. *Id.* at 1543-44.

32. *Id.* at 1551.

33. *Id.*

suant to item 7(a) is absolute in the sense that no separate duty to disclose is necessary; item 7(a), when it applies, creates a disclosure obligation, even though the instruction to the item permits the disclosure to be quite general. Materiality is not an issue. If "negotiations" are occurring as defined in *Revlon*, disclosure must be made. In contrast, as discussed above, disclosure of preliminary merger negotiations is not required under rule 10b-5, unless there is issuer trading, a duty to correct, or a voluntary statement. But, when rule 10b-5 requires disclosure, it must be detailed enough to ensure that investors are not misled.

The only appellate decision to consider the relationship between item 7(a) of schedule 14D-9 and rule 10b-5 fails to clearly recognize the distinction between them. In *Starkman v. Marathon Oil Co.*³⁴ the court, recognizing that Marathon was not required to disclose the specifics of preliminary negotiations in response to item 7(a), held that the negotiations also need not be disclosed under rule 10b-5. Marathon was the object of an unfriendly tender offer commenced by Mobil Oil. In a press release and letter to shareholders, Marathon stated that "we are determined to stay independent" and that "shareholders would be well served if Marathon remains independent."³⁵ Nonetheless, in response to item 7(a), Marathon stated that it was investigating various transactions, including "a business combination between the company and another company,"³⁶—an event that would, of course, have put an end to Marathon's independence. Subsequently, U.S. Steel commenced a friendly tender offer for Marathon Oil and eventually acquired control.

The Sixth Circuit rejected the argument that Marathon's public statements concerning its desire to "stay independent" were false and misleading under rule 10b-5 in light of its negotiations with U.S. Steel. The court explained:

The SEC and the courts have enunciated a firm rule regarding a tender offer target's duty to disclose ongoing negotiations: so long as merger or acquisition discussions are preliminary, general disclosure of the fact that such alternatives are being considered will suffice to adequately inform shareholders; a duty to disclose the possible terms of any transaction and the parties thereto arises only after agreement in principle, regarding such fundamental terms

34. 772 F.2d 231 (6th Cir. 1985), *cert. denied*, 106 S. Ct. 1195 (1986).

35. *Id.* at 235-36.

36. *Id.* at 236.

as price and structure, has been reached.³⁷

The court, referring to the instruction to item 7(a) that authorizes the target to refrain from detailed disclosure of negotiations, stated that the Commission had a "longstanding policy that negotiations need not otherwise be disclosed unless an agreement in principle has been reached."³⁸

The difficulty with the *Starkman* opinion is that it confuses the limitation in item 7(a) on the disclosure of preliminary merger negotiations with the obligation under rule 10b-5 to refrain from making materially incomplete or misleading public statements. It may be, under the circumstances in *Starkman*, that Marathon's public disclosure did not violate rule 14d-9, especially since the schedule 14D-9 was disseminated to shareholders along with the shareholder letter asserting the desire to remain independent. But if the ongoing preliminary merger negotiations were material, and if Marathon's public statements can be interpreted as denying their existence, then rule 10b-5 would require disclosure of the negotiations, despite the fact that rule 14d-9 compels only a general statement concerning them.

C. Exchange Listing Requirements

Another source of a public company's obligation to disclose preliminary merger negotiations is the listing standards of the stock exchanges on which the company's securities are traded. For example, the New York Stock Exchange imposes a general duty to promptly disclose material information. The stock exchange manual states that "a listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities."³⁹ The rules of the American Stock Exchange contain a similar requirement: "The Exchange considers the conduct of a fair and orderly market requires every listed company to make available the public information necessary for informed investing; and to take reasonable steps to ensure that all who invest in its securities enjoy equal access to such information."⁴⁰

The legal force of these listing requirements is open to some

37. *Id.* at 243.

38. *Id.* at 243 n.9.

39. *New York Stock Exchange Listed Company Manual* § 202.05 (1986).

40. *American Stock Exchange Company Guide* § 401 (1983). See also *Boston Stock Exchange, Rules of the Board of Governors*, Supplement to Chapter XXVII CCH BSE Guide (2265 and 2258); *Midwest Stock Exchange Rules*, Policy on Informing the Public, Article

question. First, the New York Stock Exchange and the American Stock Exchange requirements expressly recognize that there may be valid business reasons for not disclosing information—an exception which an issuer would presumably wish to invoke with respect to preliminary merger negotiations. The *New York Stock Exchange Listed Company Manual* states:

Negotiations leading to mergers and acquisitions . . . are the type of developments where the risk of untimely and inadvertent disclosure of corporate plans are most likely to occur. . . . Accordingly, extreme care must be used in order to keep the information on a confidential basis. Where it is possible to confine formal or informal discussions to a small group of the top management of the company or companies involved, and their individual confidential advisers where adequate security can be maintained, premature public announcement may properly be avoided.⁴¹

The American Stock Exchange recognizes a similar qualification on the obligation to make disclosure.⁴²

Second, it is unsettled whether a private party could enforce these requirements. The federal courts are split over whether an implied right of action exists against a listed issuer for failure to comply with exchange or NASD listing requirements. The greater weight of authority rejects such a cause of action.⁴³ As a practical matter, the chief sanction is the threat that the exchange will delist the company's shares if it fails to comply with its obligations as a listed company. Such a sanction is infrequently invoked and, in any event, it may be of scant concern to a company contemplating a merger which will itself result in its delisting.

Nonetheless, exchange inquiries concerning the reasons for un-

XXVIII Rule 7, Interpretation .01, CCH MSE Guide Para. 1898 at 2133; *National Association of Securities Dealer's Manual*, Schedule D, Part II Section (B)(3)(b).

41. *New York Stock Exchange Listed Company Manual* § 202.01 (1986).

42. *American Stock Exchange Company Guide* § 402 (1985).

43. *Compare* Van Germert v. Boeing Co., 520 F.2d 1373, 1380 (3d Cir.), *cert. denied*, 423 U.S. 947 (1975) (implied right of action exists) *with* Jablon v. Dean Witter & Co., 614 F.2d 677, 680-81 (9th Cir. 1980) (no private right of action exists for violation by broker of NASD "suitability" rule). *See also* State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 852-53 (2d Cir. 1981) (no implied private right of action for violation of NYSE disclosure requirements); Margaret Hall Found., Inc. v. Atlantic Fin. Management, Inc., [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,514, at 96,972 (D. Mass. Sept. 28, 1983); Chapman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,419, at 96,408 (D. Md. July 19, 1983) ("even where fraud is alleged, an implied private right of action does not exist under the rules of the NYSE and the NASD").

usual activity in a company's stock frequently trigger corporate statements denying the existence of ongoing merger negotiations. Thus, while silence concerning preliminary merger negotiations is legally an option and, in most cases, the most attractive alternative for the negotiating company, stock exchange disclosure requirements, and the resulting inquiries from exchange officials, may make complete silence infeasible.

II. MATERIALITY OF PRELIMINARY MERGER NEGOTIATIONS

Even if some duty to disclose applies, rule 10b-5 requires disclosure of preliminary merger negotiations only if information concerning them is material. The federal appellate courts are divided over when, if ever, negotiations that have not ripened into agreement are considered material.

The Supreme Court has previously defined the term "material" in the context of the proxy solicitation provisions of the Securities Exchange Act of 1934. In *TSC Industries v. Northway, Inc.*⁴⁴ the Court stated that information about a corporation will be considered material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." This standard contemplates a "showing of a substantial likelihood that . . . the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder."⁴⁵ Although *TSC Industries* arose under rule 14a-9, the federal courts of appeals have subsequently applied the test to cases arising under rule 10b-5.⁴⁶

Difficulty has arisen, however, in applying this test to contingent, future corporate events such as possible mergers. When a corporate development is certain, its significance to investors depends purely on its importance to the company's fortunes. However, when an event is not certain to occur, as in the case of a potential merger that is the subject of unresolved negotiations, a more complex analysis is necessary. The Commission has advocated the probability/magnitude test.⁴⁷ Under that approach, the materiality of a future event "will depend at any given time upon a

44. 426 U.S. 438, 449 (1976).

45. *Id.* at 449.

46. See, e.g., *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 466 n.4 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981); *Goldberg v. Meridor*, 567 F.2d 209, 218-19 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

47. See Brief for the Securities and Exchange Commission as Amicus Curiae at 8-9, *Basic Inc. v. Levinson*, No. 86-279 (U.S. filed Apr. 1987); Brief for the Securities and Exchange Commission as Amicus Curiae at 10, *Levinson v. Basic Inc.*, 786 F.2d 741 (6th Cir. 1986).

balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of [corporate] . . . activity.”⁴⁸ Two courts of appeals, however, have rejected this test in favor of a “bright-line” test: preliminary negotiations are, as a matter of law, never material until an agreement is reached on price and structure.⁴⁹ In contrast, the Sixth Circuit has adopted a more subjective standard: preliminary merger negotiations are ipso facto material if the company chooses to issue a public statement concerning them.⁵⁰

A. The Bright-Line Test

1. *Staffin v. Greenberg and Reiss v. Pan American*—Duty or Materiality?—The courts that have held that preliminary merger negotiations are per se immaterial trace their reasoning to the Third Circuit’s 1982 opinion in *Staffin v. Greenberg*⁵¹ and the Second Circuit’s decision the following year, in *Reiss v. Pan American World Airways*.⁵² Both of these opinions concluded that the defendant companies had not violated rule 10b-5 in failing to disclose the existence of preliminary merger negotiations. It appears, however, that in both cases the company was not under a duty to make such disclosure. There was no duty under rule 10b-5 in either case because neither company was trading in its own stock or had made any inaccurate public statements. In addition, neither company was under a duty to disclose the negotiations in a Commission filing. Thus, while the results in these two cases are correct, their reasoning is overbroad because they unnecessarily addressed the materiality issue.

In *Staffin* former shareholders brought suit against Bluebird, Inc., alleging that Bluebird should have disclosed that it was engaged in merger negotiations that ultimately led to the company’s acquisition at a premium over market price. The plaintiffs sold their shares after Bluebird’s initial contacts with its acquiror, but before Bluebird made a public announcement that “exploratory talks”

48. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). Accord SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983); SEC v. Mize, 615 F.2d 1046, 1054-55 (5th Cir.), cert. denied, 449 U.S. 901 (1980).

49. *Staffin v. Greenberg*, 672 F.2d 1196, 1205-07 (3d Cir. 1982); *Reiss v. Pan Am. World Airways*, 711 F.2d 11, 14 (2d Cir. 1983).

50. *Levinson v. Basic Inc.*, 786 F.2d 741 (6th Cir. 1986), cert. granted, 107 S. Ct. 1204 (1987).

51. 672 F.2d 1196 (3d Cir. 1982).

52. 711 F.2d 11 (2d Cir. 1983).

were in progress. The announcement came as a response to the unusual activity in the market for Bluebird stock.

The Third Circuit held that no disclosure of the initial merger contacts was necessary because preliminary merger discussions are "immaterial as a matter of law."⁵³ The rationale for this holding was that disclosure of such negotiations "may itself be misleading."⁵⁴ The court reasoned that "[t]hose persons who would buy stock on the basis of the occurrence of preliminary merger discussions preceding a merger which never occurs are left 'holding the bag' on a stock whose value was inflated purely by an inchoate hope."⁵⁵ Thus, in order to avoid the risk of unrealistically exciting the expectations of shareholders that a merger will occur, the Third Circuit concluded that a per se rule that preliminary merger negotiations are immaterial, and thus need not be disclosed, was preferable.

In *Reiss* former convertible debenture holders sued Pan American for its failure to disclose its efforts to acquire National Airlines. The plaintiffs had sold their shares after Pan American announced that the debentures would be called. Shortly thereafter, Pan American announced its merger with National. Although typically the primary market impact of a merger announcement is on the stock of the target rather than that of the acquiror, in this case Pan American's stock rose in value following the merger announcement. Since the plaintiff's debentures were convertible into common stock, the debentures also rose in value.

Relying on *Staffin* the Second Circuit held that information concerning the National/Pan American merger negotiations was not material at the time of the debenture-call press release:

It does not serve the underlying purposes of the securities acts to compel disclosure of merger negotiations in the not unusual circumstances before us. . . . Such negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty. Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned.⁵⁶

The Second Circuit also held that Pan American lacked scienter, an intent to deceive or defraud, which is a necessary element of

53. 672 F.2d at 1206.

54. *Id.*

55. *Id.* at 1207.

56. 711 F.2d at 14 (citations omitted).

private damage actions under rule 10b-5.⁵⁷ The court reasoned that Pan American's own natural interest would be to encourage conversion, rather than redemption pursuant to the call. Redemption required the company to distribute cash to the former debenture holders; conversion, by contrast, did not require a cash expenditure. Announcement of the pending merger negotiations would presumably have driven up the price of Pan American's stock, thus encouraging conversions. Accordingly, since the failure to disclose the negotiations was contrary to Pan American's interest, the court concluded that Pan American had not acted with scienter: "Pan Am had every reason to disclose information which would have increased the trading price of its common stock, for the higher the stock price, the greater the incentive for debentureholders to convert."⁵⁸

Although *Reiss* and *Staffin* reached the correct result, in both cases the corporations involved were not under any duty to make statements concerning their pending merger negotiations and, therefore, the complete silence of both corporations was lawful. Indeed, in *Staffin* Bluebird promptly issued a press release accurately describing its negotiations when market activity in its stock suggested a leak concerning the possible merger.⁵⁹ In *Reiss* Pan American was silent concerning merger negotiations. Unlike Bluebird, Pan American was in the process of purchasing its own securities—by calling its debentures. But, as the court noted, Pan American's failure to make disclosure concerning the merger negotiations in the context of a call announcement can hardly be viewed as fraud under rule 10b-5, because the failure to make disclosure was, if anything, contrary to Pan American's interest.⁶⁰

57. *Id.* See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197-201 (1976).

58. 711 F.2d at 14.

59. 672 F.2d at 1201. Bluebird was under a disclosure obligation during a period prior to any serious merger activity, when it had made an issuer tender offer to acquire its own securities. But all that occurred during that period was an initial contact. Standing alone, this is not material information triggering the issuer's disclosure obligations that flow from its role as a purchaser of its own securities. *Id.* at 1205-07. An unsolicited inquiry concerning merger possibilities is not in itself material. See, e.g., *Missouri Portland Cement Co. v. H.K. Porter Co.*, 535 F.2d 388, 398 (8th Cir. 1976).

60. Significantly, the lower courts in the Second Circuit have not read *Reiss* as adopting the price and structure test and have continued to hold that preliminary merger discussions can be material. In *Schlanger v. Four-Phase Sys., Inc.*, 582 F. Supp. 128, 135 (S.D.N.Y. 1984), the court characterized *Reiss* "as a case involving an omission, under circumstances where there was no duty to disclose inchoate merger plans." See also *SEC v. Gaspar*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004 (S.D.N.Y. 1985) (holding that when takeover negotiations proceed substantially beyond the exploratory stage, information about the negotiations is material).

2. *Greenfield v. Heublein*—*The extension of the Price and Structure test to Voluntary Corporate Statements.*—In *Greenfield v. Heublein, Inc.*⁶¹ the Third Circuit extended the reasoning in *Staffin* to a case in which a company voluntarily issued a press release, thus placing the company under an affirmative duty to make materially accurate statements concerning preliminary merger negotiations. The impact of *Heublein* is clouded by two facts: first, the court seems to assume that if the merger negotiations were material, Heublein was obligated to disclose them, regardless of its voluntary statement; second, the court squarely holds, over a strong dissent by the author of *Staffin*, that the corporation had not made a false statement when it denied any knowledge of the reasons for unusual stock activity, notwithstanding the fact that preliminary merger negotiations were pending.

Heublein was the object of unwanted takeover interest by General Cinema Corporation. On July 14, 1982, General Cinema informed Heublein that it was taking steps to raise cash, presumably to finance purchases of Heublein stock. That same day trading activity in Heublein's shares increased dramatically. In response to an inquiry from the New York Stock Exchange, Heublein issued a statement saying that it was "aware of no reason that would explain the activity in its stock in trading on the NYSE today."⁶² Meanwhile, Heublein stepped up efforts to negotiate a friendly merger with a "white knight," R.J. Reynolds. On July 29 Heublein announced a merger with R.J. Reynolds at \$60 per share.

Greenfield, a Heublein shareholder, had sold his stock on July 27 at \$45.25. Greenfield brought suit against Heublein, alleging that the issuance of the July 14 statement, and the failure to update it prior to July 29, violated rule 10b-5. In essence, his argument was that Heublein's July 14 statement that it was not aware of any reason that would explain the activity in its stock was either false when made, because Heublein had discussed merging with both General Cinema and R.J. Reynolds, or that the statement was still "alive" in the market, became false, and should have been corrected.

The Third Circuit conducted a two-step analysis in rejecting Greenfield's claim. First, relying on *Staffin*, it held that "because disclosure of such tentative discussions may itself be misleading to shareholders, preliminary merger discussions are immaterial as a

61. 742 F.2d 751 (3d Cir. 1984), cert. denied, 469 U.S. 1215 (1985).

62. *Id.* at 754.

matter of law.”⁶³ Further, the court concluded that merger discussions are preliminary and thus immaterial until there is an agreement on the price and structure of an actual merger:

Agreement as to price and structure provides concrete evidence of a mature understanding between the negotiating corporations. They constitute a usable and definite measure for determining when disclosures need be made. Finally, with both price and structure agreed to, there is only a minimal chance that a public announcement would quash the deal or that the investing public would be misled as to likely corporate activity.⁶⁴

Since there was no agreement as to price and structure with R.J. Reynolds until sometime after Greenfield sold his shares, and since there was never an agreement with General Cinema, the court held that Greenfield could not recover for the failure to disclose either set of negotiations.

The Third Circuit next considered the question of whether the July 14 statement was false and concluded that it was not. Although Heublein executives “clearly knew of information that might have accounted for the increase in trading, there is no indication that any of this privileged information had been leaked or that they knew of, or had, information that insiders were engaged in trading.”⁶⁵ Accordingly, in the court’s view, the statement that Heublein was “aware of no reason” for unusual activity in its stock was literally true—Heublein was not aware of a leak, and, therefore, it was not aware of any reason for unusual activity in its stock. Judge Higginbotham vigorously dissented from this portion of the opinion, stating:

The majority seems determined to rest its entire case on the belief that corporate executives should be able to suggest that all is proceeding at a routine, business-as-usual pace when that is not the truth so long as an agreement in principle has not been reached at the time the statement was issued. Given the majority’s concession that in this case Heublein knew of information that might have accounted for the increase in the trading of Heublein’s stock and given the possibility that information could have been leaked to or ascertained by some investors, the statement by Heublein that it was aware of no reason to explain the

63. *Id.* at 756.

64. *Id.* at 757.

65. *Id.* at 759.

increase in trading of its stock was false or misleading or so incomplete as to mislead.⁶⁶

The majority's conclusion that Heublein's July 14 statement was not misleading is difficult to accept; in this regard, Judge Higginbotham's dissent is persuasive. Indeed, the Commission has indicated that it disagrees with the decision in *Heublein*.⁶⁷ However, if the holding that the July 14 statement was not misleading is accepted, then the court's analysis of the materiality of Heublein's merger negotiations with General Cinema and R.J. Reynolds is unnecessary to its decision. If the July 14 statement was not inaccurate, Heublein was under no duty to disclose its negotiations, regardless of their materiality.

3. *Flamm v. Eberstadt*—*Seventh Circuit Adoption of the Price and Structure Test*.—The Seventh Circuit recently adopted the price and structure test in a case that would also seem to be better analyzed on the basis of the absence of any duty to make disclosure. In *Flamm v. Eberstadt*⁶⁸ Microdot was the object of a hostile tender offer by General Cable. Microdot issued a statement asserting that it would "employ all resources at our disposal to defeat the offer."⁶⁹ Microdot also published an advertisement deploring the fact that successful growth companies were habitually the targets of tender offers. At the same time, however, Microdot began to seek a "white knight" and eventually consummated a merger with Northwest Industries. Flamm, a Microdot shareholder, sold his shares after Microdot announced its resolve to defeat the General Cable offer, but before the merger with Northwest Industries was announced. Flamm brought suit against Microdot alleging that the nonpublic negotiations leading up to the Northwest offer were material information that should have been disclosed pursuant to rule 10b-5.

The court of appeals affirmed a verdict in favor of Microdot, expressly adopting the price and structure rule. The court cited *Staffin* and *Reiss* for the proposition that "efforts by public corporations to arrange mergers are immaterial . . . as a matter of law, until the firms have agreed on the 'price and structure' of the deal."⁷⁰ Judge Easterbrook, writing for the majority, cited three possible reasons for this conclusion. First, the court found that "disclosure of

66. *Id.* at 765.

67. *Carnation* release, *supra* note 2, at 87,576.

68. 814 F.2d 1169 (7th Cir. 1987).

69. *Id.* at 1171.

70. *Id.* at 1174.

ongoing negotiations may befuddle the investors, leading them to think that the outcome is more certain than it is." Second, the court found that premature disclosure may hinder the negotiation of the merger, "destroying the source of the value sought to be disclosed." Third, the court acknowledged a "need to create a bright-line rule that will allow firms to plan corporate transactions with the assurance that they will not be condemned no matter which way they proceed on disclosure."⁷¹ While the court rejected the first rationale, it concluded that the second and the third provide strong support for the price and structure test. Since, under that test, the Northwest/Microdot merger negotiations were not material, it held that Microdot was not obligated to disclose them.

The court also considered whether Microdot's voluntary statement that it would seek to defeat General Cable's offer was tantamount to a false denial of the existence of merger negotiations. The court concluded that this statement cannot be read as such a denial since a reasonable shareholder would recognize that a merger with a friendly party is a common means of defeating hostile takeover bids and that Microdot's publicized concern for the independence of growth companies did not negate the possibility that it would use such a tactic. Thus, since Microdot's voluntary statement was not false, the court did not analyze the circumstances under which false corporate denials of merger negotiations are material.⁷²

Like *Staffin* and *Reiss* upon which it relied, *Flamm* could have been decided without reaching the issue of when preliminary merger negotiations become material. The court held that Microdot made no statement at all concerning the pendency of merger negotiations: "Ours is therefore a case of silence on the subject of the omitted information."⁷³ Since the company chose to remain silent, it was therefore under no obligation to disclose its discussions with Northwest, whether material or not.⁷⁴ Although

71. *Id.* at 1175.

72. *Flamm* characterized this as "a difficult question." *Id.* at 1178. In declining to consider whether a false denial of the pendency of preliminary merger negotiations is actionable, Judge Easterbrook stated: "For all practical purposes, Microdot was mum on its strategy for defeating General Cable's bid. . . . We therefore affirm the judgment without choosing between *Greenfield* and *Levinson*." *Id.* at 1179.

73. *Id.*

74. Subsequent to *Flamm*, in *Jordan v. Duff and Phelps, Inc.*, 815 F.2d 429, 431 (7th Cir. 1987), the court reiterated that, under *Flamm*, merger negotiations would not have to be disclosed prior to agreement on price and structure in the case of a public company. In *Jordan* this statement is dictum, since that case involves a closely held company. The Seventh Circuit has previously held that, in the case of a closely held company, the price and structure test is inapplicable, and information concerning preliminary merger

not relevant to the court's holding, Judge Easterbrook observed that the firm's right to remain silent may be illusory:

Suppose a firm is engaged in negotiations that are best kept quiet, and the Exchange asks whether new developments account for activity in its stock. If the firm says yes and it says why, the cat is out of the bag; if the firm says no, it faces liability for fraud; if the firm says "no comment" that is the same thing as saying "yes" because investors will deduce the truth.⁷⁵

B. Levinson v. Basic: Materiality by Virtue of Misstatement

While the Seventh Circuit has endorsed the Third Circuit's price and structure test,⁷⁶ the Sixth Circuit, in *Levinson v. Basic Inc.*, expressly rejected it. Although the rationale for the *Levinson* holding is not completely clear, the court seems to formulate a test of materiality that attaches significance to the fact that the corporation has chosen to speak on a particular subject. In addition, the Sixth Circuit has sided with Judge Higginbotham's dissent in *Heublein* and rejected the Third Circuit's conclusion that "no corporate developments" statements are not misleading if management is aware of developments but has no reason to believe those developments have leaked to the market.

Levinson, like *Heublein*, involved voluntary corporate statements disclaiming knowledge of the reasons for unusual activity in the company's stock. One statement asserted flatly that no negotiations were underway with any company for a merger. That statement also recited, as did two subsequent statements, that management was "unaware of any present or pending corporate development" that would account for the recent unusual trading activity in the company's stock. Plaintiffs asserted that these statements were false or misleading because, in fact, *Basic* was engaged in merger negotiations with Combustion Engineering. Subsequent to the plaintiffs' sales of their shares, *Basic* announced its approval of a tender offer by Combustion at a price substantially in excess of the market value.

The Sixth Circuit held that when a corporation issues a statement denying the existence of merger negotiations, "information concerning ongoing acquisition discussions becomes material by *vir-*

negotiations may be material. See *Michaels v. Michaels*, 767 F.2d 1185, 1195-96 (7th Cir. 1985), *cert. denied*, 106 S. Ct. 797 (1986).

75. *Flamm*, 814 F.2d at 1178.

76. 786 F.2d 741 (6th Cir. 1986), *cert. granted*, 107 S. Ct. 1204 (1987).

true of the statement denying their existence."⁷⁷ The court distinguished the voluntary false statement situation from cases, like *Staffin*, in which rule 10b-5 liability is predicated on the corporation's remaining silent in the face of an affirmative duty to disclose material information:

In analyzing whether information regarding merger discussions is material, such that it must be affirmatively disclosed to avoid a violation of Rule 10b-5, the discussions and their progress are the primary considerations. However, once a statement is made denying the existence of any discussions, even discussions that may not have been material in the absence of the denial are material because they make the statement made untrue.⁷⁸

Correspondingly, the Sixth Circuit expressly disagreed with *Heublein's* holding that merger negotiations are not material until the parties have agreed on price and structure.⁷⁹

In addition, the Sixth Circuit rejected the argument that Basic's statements were not misleading. Implicitly agreeing with the dissent in *Heublein*, the *Levinson* court said that even if Basic's denial of knowledge of corporate developments accounting for high trading volume in its stock were literally true, "in that Basic, for some reason, never knew the reason for the unusual market activity,"⁸⁰ they "could reasonably be read broadly by the public as flat disclaimers of any significant corporate developments that might account for the high volume of stock activity."⁸¹ The court also concluded that Basic's statement that "no negotiations" were occurring was misleading, if not patently untrue, reasoning that:

The average investor does not necessarily know the technical and legal definition of these words as used by Basic. A statement that 'no negotiations' were occurring could reasonably be read to state that no contacts of any kind whatsoever regarding merger had occurred.⁸²

C. *The Probability/Magnitude Test—The Position of the Securities and Exchange Commission*

The Securities and Exchange Commission has taken the posi-

77. *Id.* at 748 (emphasis in original).

78. *Id.* at 749 (footnote omitted).

79. *Id.* at 748-49.

80. *Id.* at 747.

81. *Id.*

82. *Id.*

tion that neither the price and structure rule nor the *Levinson* test is the proper basis for determining when preliminary merger negotiations cross the threshold of materiality.⁸³ The Third Circuit's test could, as the Commission has pointed out in urging that certiorari be granted, permit corporations "freely to issue intentionally false or misleading statements in denying merger talks that any reasonable investor would consider important to his investment decision, misleading investors into making investment decisions on the basis of incorrect information."⁸⁴ In contrast, the *Levinson* opinion equates falsehood and materiality and, thus, "would appear to render any false statement, regardless of how trivial, per se material."⁸⁵ In *Levinson* the Commission had argued as amicus curiae in the Sixth Circuit that the proper standard for judging the materiality of merger negotiations is the probability/magnitude test articulated by the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*⁸⁶ Under that test merger negotiations are material if their anticipated magnitude, balanced against their likely probability, constitutes a fact of which a reasonable investor would want to be informed.

1. *In the Matter of Carnation Co.*—The Commission applied these principles in issuing its report of investigation in *In the Matter of Carnation Co.*⁸⁷ In July 1984 senior Carnation officials met with senior officials of Nestle to discuss the possibility of Nestle's acquiring Carnation. Nestle informed Carnation that it would terminate discussions if Carnation made any public disclosure of Nestle's contacts. On August 7, Carnation's stock price increased \$4 5/8 to \$66 5/8, and the Dow Jones Newswire carried a story quoting Carnation's treasurer as stating: "There is no news from the company and no corporate developments that would account for the stock action."⁸⁸ In fact, the treasurer was not personally aware of the discussions between Carnation and Nestle.

On August 9, when senior officials of the two companies again met, a possible acquisition price was discussed, but rejected by Car-

83. Brief for the Securities and Exchange Commission as Amicus Curiae at 14-18. *Basic Inc. v. Levinson*, No. 86-279 (U.S. filed Apr. 1987).

84. Brief for the United States as Amicus Curiae at 11-12, *Basic Inc. v. Levinson*, No. 86-279 (U.S. filed Jan. 1987) (footnotes omitted).

85. *Id.* at 14.

86. Brief for the Securities and Exchange Commission as Amicus Curiae at 6-19, *Levinson v. Basic Inc.*, 786 F.2d 741 (6th Cir. 1986).

87. *Carnation* release, *supra* note 2. This report, pursuant to section 21(a) of the Securities Exchange Act, 15 U.S.C. § 78u(a) (1982), was issued with the consent of Carnation, which neither admitted nor denied any of the allegations therein.

88. *Carnation* release, *supra* note 2, at 87,594.

nation. Further meetings were scheduled for late August. On August 20, Carnation's investment banker informed Carnation's chairman, at his request, that \$90 per share would be a fair price for Carnation. On August 21, while a meeting between Nestle and Carnation officials was in progress in Switzerland, Carnation's treasurer, still unaware of the existence of the negotiations, again informed the press that Carnation knew "of no corporate reason for the recent surge in its stock price."⁸⁹ The newswire story indicated that:

[H]e had been informed of rumors in the market that Carnation is about to be acquired by Nestle S.A. or be taken private [B]ut to the best of my knowledge, there is nothing to substantiate either one of them "We are not negotiating with anyone."⁹⁰

On September 4, 1984, Nestle and Carnation announced an agreement whereby Nestle would acquire Carnation at \$83 per share.

In its report the Commission addressed both the issue of the duty to disclose and the issue of the materiality of preliminary merger negotiations. With respect to the former, the Commission stated that publicly-traded companies have a duty under rule 10b-5 to refrain from making public statements that are materially false or misleading. An issuer who makes a statement while aware of nonpublic information concerning acquisition disclosures "has an obligation to disclose sufficient information concerning the discussions to prevent statements made from being materially misleading."⁹¹ The Commission added, however, that it:

encourages public companies to respond promptly to market rumors concerning material corporate developments. . . . However, an issuer who wants to prevent the premature disclosure of nonpublic preliminary merger negotiations can, in appropriate circumstances, give a "no comment" response to press inquiries concerning rumors or unusual market activity.⁹²

With regard to the materiality of preliminary merger negotiations, the Commission set forth the fundamental standard articulated by the Supreme Court in *TSC Industries v. Northway, Inc.*⁹³ "When an issuer makes a public statement, information concerning

89. *Id.*

90. *Id.*

91. *Id.* at 87,595.

92. *Id.* at 87,595 n.6.

93. 426 U.S. 438 (1976).

preliminary acquisition discussions is material and must be disclosed if the information assumes 'actual significance in the deliberation of' and significantly alters 'the total mix of information available [to]' the reasonable shareholder."⁹⁴ In this connection, the Commission noted that: "The Second Circuit has stated that materiality 'will depend at any given time upon the balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'"⁹⁵ Applying these principles to the *Carnation* facts the Commission found that the August 7 "no corporate developments" statement was materially misleading.

Finally, the Commission addressed the question that had divided the *Heublein* panel—whether denials of the existence of corporate developments that would influence stock trading were in fact misleading when the company was unaware of leaks. The Commission found that the August 21 *Carnation* press release that stated that the company knew of no corporate reason for the recent surge in its stock price was materially false and misleading. The Commission recognized that the Third Circuit had held to the contrary on similar facts and stated simply that the "Commission believes that *Heublein* was wrongly decided."⁹⁶

2. *Policy Implications.*—It is, perhaps, not surprising that the Commission took the position in *Carnation* that a corporation may not falsely deny the pendency of merger negotiations when pending negotiations would be significant to a reasonable shareholder. The notion that public companies may issue false corporate press releases is understandably unattractive to the agency charged with administering and enforcing the full disclosure and antifraud provisions of the federal securities laws. In addition, the Commission may be uneasy about the potential relationship between a case like *Carnation* and insider trading enforcement. If preliminary negotiations are immaterial from the company's standpoint, the materiality of the same facts from the standpoint of a corporate officer, investment banker, or other individual privy to the negotiations, who buys the target company's stock in hopes of turning a quick profit, might be questioned. Certain of the Commission's insider

94. *Carnation* release, *supra* note 2, at 87,597 (quoting *TSC Industries*, 426 U.S. at 449).

95. *Id.* at n.7 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969)).

96. *Id.* at n.8.

trading cases have involved similar scenarios.⁹⁷ If preliminary merger negotiations are immaterial, then these traders arguably may act with impunity. That is a conclusion which would undoubtedly trouble the Commission.

At the same time, the Commission has recognized that care must be used in applying its *Carnation* holding to other contexts. For example, the Commission's observation⁹⁸ in *Carnation* that the issuer may respond with "no comment" when confronted with an inquiry concerning unusual trading volume when confidential merger negotiations are pending may have an unintended perverse effect. In order to avoid the risks of a duty to correct if negotiations do commence, prudent companies may well respond with "no comment" to all inquiries concerning the reasons for unusual stock market activity, even when no corporate developments such as merger negotiations are pending. If this occurs, then the effect of the Commission's position is to discourage misleading disclosure at the expense of the dissemination of accurate information to the trading markets.⁹⁹ One member of the Commission has suggested that, in order to alleviate this problem, the Commission should adopt a safe harbor rule that would protect companies from the obligation to update truthful denials of merger negotiations, even if negotiations subsequently commence.¹⁰⁰

Similarly, the probability/magnitude test requires care in its application. Since the magnitude of a merger for a small company may be great, virtually all preliminary negotiations would be considered material, even if there were a small probability that the deal would be consummated. In effect, the materiality requirement may be written out of the law. Of course, as discussed above, it would not

97. See, e.g., SEC v. Siegel, No. 87 Civ. 0963 (S.D.N.Y. filed Feb. 13, 1987), discussed in Lit. Release No. 11,354, 37 SEC Docket 1276 (Mar. 3, 1987); SEC v. Boesky, No. 86 Civ. 8767 (S.D.N.Y. Nov. 14, 1986), discussed in Lit. Release No. 11,288, 37 SEC Docket 78 (Dec. 2, 1986); SEC v. Katz, No. 86 Civ. 6,008 (S.D.N.Y. filed Aug. 7, 1986), discussed in Lit. Release No. 11,185, 36 SEC Docket 448 (Aug. 19, 1986); SEC v. Levine, No. 86 Civ. 3726 (S.D.N.Y. May 12, 1986), discussed in Lit. Release No. 11,095, 35 SEC Docket 1212 (May 27, 1986); SEC v. Thayer, No. CA-3-84-0471-R (N.D. Tex. May 7, 1985), discussed in Lit. Release No. 10,746, 33 SEC Docket 74 (May 21, 1985); SEC v. Gaspar, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004 (S.D.N.Y. Apr. 15, 1985).

98. See *supra* text accompanying note 92.

99. See SEC Forum, 18 Sec. Reg. & L. Rep. (BNA) 251, 253-54 (Feb. 21, 1986). For example, a company may be discouraged from issuing truthful denials of rumored merger negotiations.

100. See Grundfest, *Carnation Revisited: Toward an Optimal Merger Disclosure and Rumor Response Policy*, Address to the Federal Regulation of Securities Committee, American Bar Association (Apr. 15, 1986), at 12.

follow that there is a duty to disclose all such negotiations; the duty to disclose and the materiality of the negotiations are separate inquiries. Moreover, as the Commission noted in its *Levinson* brief, the potential merger must not be so remote as to preclude a finding of a "substantial likelihood that a reasonable [investor] would consider [the negotiations] important."¹⁰¹ Thus, even potential mergers which would be of tremendous magnitude to a corporation may not be material at the formative stages, if the probability of occurrence fails to meet this basic threshold.

V. CONCLUSION

At first blush, the materiality of preliminary merger negotiations seems self-evident. In *SEC v. Geon Industries*, a case in which "embryonic" merger talks were held to be material, Judge Friendly noted that "[a] merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death . . . even though the mortality rate of mergers in such formative stages is doubtless high."¹⁰² Experience in the Commission's insider trading enforcement program confirms the dramatic market effect that information concerning even the possibility of a tender offer or merger may have. Clearly, the possibility of an acquisition is often of overwhelming significance to investors.

In contrast, the Third Circuit concluded in *Heublein* that premature disclosure of merger negotiations may be more damaging to investors than confidentiality. Expectations of a merger transaction may inflate the price of the stock, causing purchasers to buy at unjustifiably high prices that inevitably drop if the expected acquisition fails to materialize. Moreover, the Seventh Circuit has found that since a potential acquiror may insist on confidentiality in order to avoid driving up the target's price, a rule that forces disclosure of otherwise nonpublic negotiations may harm more investors than it protects because it would destroy the chances for a profitable merger. "Investors seek monetary returns, and few want disclosure for its own sake. To the extent investors' wealth depends on withholding information, all favor that course."¹⁰³

By granting certiorari in *Levinson* the Supreme Court has undertaken to resolve the issue of when preliminary merger negotiations

101. Brief for the Securities and Exchange Commission as Amicus Curiae at 4-5, *Basic Inc. v. Levinson*, No. 86-279 (U.S. filed Apr. 1987) (quoting *TSC Indus. v. Northway, Inc.* 426 U.S. 438, 449 (1976) (emphasis added)).

102. 531 F.2d 39, 47-48 (2d Cir. 1976).

103. *Flamm v. Eberstadt*, 814 F.2d 1169, 1176 (7th Cir. 1987).

become material.¹⁰⁴ The decision will likely have far-reaching implications. Since materiality is an element in any rule 10b-5 action based on false, misleading, or incomplete disclosure, the Court's definition of that term will influence a wide range of cases. In addition, by resolving this issue, the Court may shed needed light on the interplay between the duty to make disclosure and the materiality of the information to be disclosed.

104. A second issue before the court in *Levinson* is whether a plaintiff who trades in a corporation's stock after issuance of a materially false corporate statement is entitled to a rebuttable presumption that he relied on the integrity of the market price in so trading. That is, the case presents the issue of whether sellers may establish that a false corporate statement caused their loss, not by demonstrating that they relied specifically on the false statement, but on the basis of a presumption that the false statement influenced the market price of the security. The Commission has taken the position that such a presumption is justified. See Brief for the Securities and Exchange Commission as Amicus Curiae at 21-27, *Basic Inc. v. Levinson*, No. 86-279 (U.S. filed Apr. 1987).